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699225—46

# In the Supreme Court of the United States

OCTOBER TERM, 1946

No. 136

H. GATES LLOYD, PETITIONER

*v.*

COMMISSIONER OF INTERNAL REVENUE

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT*

## BRIEF FOR THE RESPONDENT IN OPPOSITION

### OPINIONS BELOW

The opinion of the Tax Court of the United States (R. 72a–97a)[1] is reported in 4 T. C. 829. The opinion of the Circuit Court of Appeals (R. 98–105) is reported in 154 F. 2d 643.

### JURISDICTION

The judgment of the Circuit Court of Appeals was entered on March 4, 1946. (R. 106.) The petition for a writ of certiorari was filed on June

[1] The record references are to the Appendix to the brief for petitioner filed in the Circuit Court of Appeals. The Clerk of the Third Circuit has certified that the record in the case is in his office. (R. 106.)

3, 1946. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Where municipal bonds are purchased and shortly thereafter unmatured coupons are detached and sold separately though almost simultaneously with the resale of the bonds, are the proceeds exempt from tax as "interest" within the meaning of Section 22 (b) (4) of the Internal Revenue Code?

2. Assuming that the proceeds from the sale of the unmatured detached coupons do not constitute "interest," are they exempt from tax under the Constitution?

STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from * * * sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; * * *

* * * * *

(b) *Exclusions from Gross Income.*—The following items shall not be included in gross income and shall be exempt from taxation under this chapter:

* * * * *

(4) *Tax-free interest.*—Interest upon (A) the obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia; * * * Every person owning any of the obligations enumerated in clause (A), (B), or (C) shall, in the return required by this chapter, submit a statement showing the number and amount of such obligations owned by him and the income received therefrom, in such form and with such information as the Commissioner may require. * * *

* * * * *

(26 U. S. C. 1940 ed., Sec. 22.)

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) *Amount Realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

* * * * *

(26 U. S. C. 1940 ed., Sec. 111.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.22 (b) (4)–1. *Interest upon State obligations.*—Interest upon the obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia is exempt from the income tax. Obligations issued by or on behalf of the State or Territory or a duly organized political subdivision acting by constituted authorities empowered to issue such obligations, are the obligations of a State or Territory or a political subdivision thereof. Special tax bills issued for special benefits to property, if such tax bills are legally collectible only from owners of the property benefited, are not the obligations of a State, Territory, or political subdivision. The term "political subdivision," within the meaning of the exemption, denotes any division of the State or Territory which is a municipal corporation, or to which has been delegated the right to exercise part of the sovereign power of the State or Territory. As thus defined, a political subdivision of a State or Territory may or may not, for the purpose of exemption, include special assessment districts so created, such as road, water, sewer, gas, light, reclamation, drainage, irrigation, levee, school, harbor, port improvement, and similar districts and divisions of a State or Territory.

STATEMENT

Most of the facts were stipulated. The stipulation and the exhibits attached were incorporated

by reference in the Tax Court's findings of fact (R. 74a–88a), which may be summarized as follows:

The taxpayer was a member of Drexel and Company, a banking partnership (R. 75a), which in turn was a member of a syndicate (R. 76a) which entered into an agreement with the City of Philadelphia for refunding various bond issues of the city (R. 79a). In the agreement the syndicate agreed to undertake to effect the exchange of new refunding bonds for such old outstanding bonds of the city as might be surrendered in accordance with the terms of the plan, and the city agreed to authorize the issuance of such new refunding bonds. (R. 79a.)

The plan called for the refunding of bonds of various issues aggregating about $131,000,000, which bore interest at rates varying from four percent to four and one-half percent and which matured at various dates from 1952 to 1977, but which were callable at the option of the city during the years 1942 to 1947, inclusive. Under the plan, the new bonds provided for interest at the rate provided in the old bonds until the respective first optional call dates of the old bonds, and bore interest at reduced rates varying from two and one-fourth percent to three and one-fourth percent thereafter. The new bonds, with the exception of one series, were callable at the option of the city during the years 1948 to 1958, inclusive,

and matured at different dates from 1949 to 1973. (R. 80a–81a.)

The new refunding bonds were issued by the city in both coupon and registered form. The bonds issued in coupon form had attached thereto two types of coupons designated, respectively, "A" and "B". The A coupons represented interest during the life of each new bond at the reduced rate provided for in the plan. The B coupons represented the difference between the new reduced rate of interest and the rate of interest of each old bond, and ran from July 1, 1941, until the respective first optional call dates of the old bonds. The purpose of the two sets of coupons was, first, to provide for a reduction in the interest rate only after the respective first optional call dates of the old bonds, and second, to make it possible for investors to detach the B coupons and thus have instruments carrying a single rate of interest which would be familiar to investors and which would enable the bonds to be traded in the market, thus providing inducement to the holders to make the exchanges desired by the city. (R. 81a.)

Under the contract between the city and the syndicate, the latter was given the right to deal in both the old and the new bonds for its own account. (R. 80a.) Pursuant to this provision, the syndicate during the taxable year purchased old bonds at a cost of about $17,159,000 (R. 84a),

exchanged them for new bonds (R. 84a–85a), detached the B coupons, sold them for about $647,000 (R. 85a) and sold the new bonds with the A coupons attached for about $16,517,000 (R. 85a–86a). As a result of these transactions, the syndicate in its income tax return reported a loss of about $642,000 and treated the proceeds from the sale of B coupons in the amount of about $662,000 as tax-exempt interest. (R. 77a.)

Upon the audit of the return of the syndicate, the Internal Revenue Agent in Charge determined that the "proceeds from discount of 'B' coupons" in the amount of about $662,000 should not be considered as tax-free interest. This action resulted in changing Drexel and Company's "distributive share of the syndicate tax exempt interest," and also in increasing the taxpayer's partnership income in the amount of about $5,800. (R. 87a–88a.) These determinations of the Revenue Agent were adopted by the Commissioner in the latter's determination of the deficiency in this case. (R. 88a.)

The Tax Court decided that in determining the partnership's distributive share of the income of the syndicate and taxpayer's distributive share of the income of the partnership, the proceeds from the discount of B coupons are not tax-free interest within the meaning of Section 22 (b) (4) of the Internal Revenue Code, but must be considered along with the selling price of the new bonds with

the A coupons attached in determining the gain or loss from the entire transaction; and that any gain resulting from the purchase and exchange and sale of the bonds is to be included in gross income under Section 22 (a) of the Internal Revenue Code. The taxpayer appealed to the Circuit Court of Appeals for the Third Circuit, which affirmed the decision of the Tax Court.

**ARGUMENT**

1. The petitioner does not allege that the decision of the court below is in direct conflict with the decision of another Circuit Court of Appeals, and not one of the decisions of this Court to which the petitioner refers involves the same statutory provision or similar facts.

The decision of the court below, which affirmed the unanimous decision of the Tax Court,[2] is correct. The principal question in the case is whether the proceeds from the sale of the unmatured B coupons detached from City of Philadelphia bonds and sold separately constitute "interest" within the meaning of Section 22 (b) (4) of the Internal Revenue Code, *supra*. Inasmuch as Section 22 (b) (4) exempts interest on certain obligations from the federal income tax, it must be strictly construed; exemptions from taxation cannot rest upon mere implication. See *United States* v. *Stewart*, 311 U. S. 60, 71..

[2] The Tax Court's decision was reviewed by the entire court. (R. 97a.)

This Court has had occasion to define the term "interest" and has held that interest is the amount which one has contracted to pay for the use of borrowed money; the amount actually paid during the taxable year as interest; compensation paid for the use of money. See *Deputy* v. *duPont*, 308 U. S. 488, 497–498; *Old Colony R. Co.* v. *Commissioner*, 284 U. S. 552, 560–561.[3] Compare *Equitable Society* v. *Commissioner*, 321 U. S. 560, 564. The proceeds from the sale of the B coupons could not qualify under this definition of "interest," because under the circumstances of this case the syndicate did not lend the City of Philadelphia money for any appreciable period of time. The purchase of old bonds, exchange of old for new bonds, detachment of B coupons, sale of B coupons to one party and sale of the new bonds with A coupons to another party, all took place "almost simultaneously." (R. 90a.) Therefore, there was no opportunity for interest to accrue on money lent.[4] The Tax Court so held (R. 91a), and the court below agreed (R. 103).

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[3] While this Court was construing the word "interest" as used in Section 23 of the Revenue Act or the corresponding provision of earlier Revenue Acts in these cases, there is no reason to believe that the term would not have the same meaning in Section 22 of the Internal Revenue Code.

[4] The case does not present the question of the treatment of accrued interest in case of a sale of bonds between interest dates where the sale agreement specifies a division. (See R. 91a–94a.)

The petitioner relies upon a number of decisions of this Court relating to anticipatory dispositions of rights, or the evidence of rights to receive income. (Br. 11.) None of these cases, however, involves the construction of the word "interest" in Section 22 (b) (4) and none involves facts similar to those in this case. The only case cited by the petitioner which involves the disposition of unmatured bond coupons is *Helvering* v. *Horst,* 311 U. S. 112. In that case the taxpayer detached coupons from his bonds and gave them to his son just before maturity and his son collected the proceeds of the coupons. The question was whether the proceeds of the coupons constituted income to the donor-taxpayer, not whether they constituted interest. That case differs materially from this case where the syndicate sold the newly acquired bonds to one party and the coupons to another before interest had accrued on the coupons; the real question in this case is whether the proceeds from the *sale* of the coupons represented part of the proceeds of the bonds.

The Tax Court decided, and the court below agreed, that the proceeds from the sale of B coupons represented a return of capital. The substance of the transaction was that the syndicate bought outstanding bonds for $17,159,994.59, exchanged those bonds for new bonds, detached the B coupons, sold the B coupons for $647,630.38, sold the new bonds with A coupons attached for

$16,517,164.46. (R. 84a–86a.) All of these transactions took place almost simultaneously. (R. 90a.) As a result of these transactions, the syndicate claimed a loss of $642,830.13, representing the difference between the amount it paid for the outstanding bonds and the amount it received for the new bonds with A coupons attached. The proceeds from the sale of B coupons, namely, $662,944.60, were treated as tax-exempt interest. (R. 77a.) But the Commissioner determined, the Tax Court held, and the court below agreed, that the proceeds from the sale of the B coupons represented part of the return of capital and therefore must be added to the sum of $16,517,164.46, representing the proceeds from the sale of new bonds with only A coupons attached. Clearly, the fact that the B coupons were detached and disposed of separately cannot alter the substance of the transaction. While there is no court decision directly in point, there is an analogous decision which tends to support the decision of the Tax Court and of the court below. See *Clyde C. Pierce Corp* v. *Commissioner,* 120 F. 2d 206 (C. C. A. 5th).

As the court below held, whether the issue is regarded as one for independent judgment of the reviewing court or one in which judicial review is limited by the principles established by *Dobson* v. *Commissioner,* 320 U. S. 489, and *Kelley Co.* v. *Commissioner,* decided January 7, 1946, not yet

reported, the decision of the Tax Court was properly affirmed.

2. The petitioner assigns as another reason for granting the writ in this case that the imposition of income tax upon the proceeds from the sale of B coupons imposes a burden upon the power of the city to borrow money and destroys a substantial measure of protection which is intended to be afforded a municipality under the Constitution. (Br. 13.) If the proceeds from the sale of the B coupons are interest, no constitutional question arises because they are exempt from tax under Section 22 (b) (4) of the Internal Revenue Code. If, however, they represent part of the proceeds from the sale of the new bonds, as the Tax Court and the court below decided, then they are not interest. They are not exempt under Section 22 (b) (4), and this Court has held that they may constitutionally be subjected to income tax to the extent that they represent a gain from the sale of property.[5] *Willcuts* v. *Bunn*, 282 U. S.

[5] In support of the petitioner's argument, he cites *Pollock* v. *Farmers' Loan & Trust Co.*, 157 U. S. 429, on rehearing, 158 U. S. 601. Since, for the reasons stated in *Willcuts* v. *Bunn*, *supra*, the *Pollock* case is entirely inapplicable, it is unnecessary to consider the question of the continued authority of the *Pollock* case. We think it proper to point out, however, that in our view this Court has rejected the reasoning of the *Pollock* case and has expressly overruled the principal authorities upon which it was predicated. *N. Y. ex rel. Cohn* v. *Graves*, 300 U. S. 308; *Hale* v. *State Board*, 302 U. S. 95, 107; *O'Malley* v. *Woodrough*, 307 U. S. 277; *Graves* v. *N. Y. ex rel. O'Keefe*, 306 U. S. 466.

216; *United States* v. *Stewart*, 311 U. S. 60. Since these cases seem to be controlling, there is no substantial constitutional question presented by the facts of this case.

## CONCLUSION

There is no direct conflict of decisions. The decision of the court below is correct, and no substantial constitutional question is presented. Therefore, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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JUNE, 1946.

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